Financial transactions taxes:
the international experience
and the lessons for Canada

Background Paper

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FINANCIAL TRANSACTIONS TAXES: THE INTERNATIONAL EXPERIENCE AND THE LESSONS FOR CANADA

Marion G. Wrobel
Senior Analyst

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A financial transactions tax can be generally thought of as any tax, fee, or duty, imposed by a government upon the sale, purchase, transfer, registration, etc. of a financial instrument -- it is, for the most part, a turnover tax. It can be broadly based or it can exempt a variety of instruments, or transactions by certain types of traders. It can be an *ad valorem* tax or a specific tax. It can be levied against transactions by residents or it can be levied against domestic transactions, or both. The law can levy the tax on buyers (as in the United Kingdom), sellers (as in Japan), or both (as in France).

This paper looks at the international experience with financial transactions taxes (FTTs). It is a companion piece to the background paper BP-418E, *Financial Transactions Taxes: Pros, Cons, Design Issues and Revenue Estimates*.

A number of countries have had an FTT for some time. An early example was the American tax on the time sales of gold ("forward contracts" in today's nomenclature) imposed during the Civil War.

As a general rule, the financial transactions taxes found in other countries do not apply to such activities as bank withdrawals, cheque writing, or obtaining financing for a car or home. In Brazil, a temporary tax of 25 basis points[1] on bank withdrawals was introduced in 1993, with a variety of special measures for withdrawals of salary, pension benefits etc.[2] This tax was, however, intended as a temporary measure in response to a financial crisis; it was eliminated at the end of 1994.

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(1) A basis point is equal to one-one hundredth of a percentage point.

(2) "Brazil: Financial Transactions Tax," *International Tax Digest*, Vol. 5, No. 3, May-June 1993.

The international experience is based on a wide variety of tax designs. Often, transactions outside national boundaries are not subject to tax; where they are so subject, they pose considerable enforcement problems. Trading in national government securities tends not to be subject to the tax. Specialized traders, such as market makers or others providing liquidity to the market, are often not subject to tax on their trades or are subject to reduced tax rates. These features can significantly reduce the tax base upon which the FTT is applied.

Table 1 presents an international comparison of direct revenues from FTT-type taxes in the mid 1980s. It measures revenue against three different bases to give some indication as to the revenue fertility of these taxes.

TABLE 1
TRANSACTIONS TAXES AND REVENUES

COUNTRY	TAX (in basis points)	TAX REVENUE AS A PERCENTAGE OF:		
		TOTAL REVENUE	GNP	MARKET VALUE OF EQUITY
FRANCE	30 & 15	0.26%	0.12%	1.19%
GERMANY	25	0.14%	0.04%	0.28%
ITALY	15	1.10%	0.38%	6.10%
JAPAN	18 & 55	1.42%	0.17%	0.34%
NETHERLANDS	50 on small trades	0.63%	0.32%	1.17%
SWEDEN	100	0.87%	0.36%	1.55%
SWITZERLAND	15 & 30	2.33%	0.48%	0.94%
UNITED KINGDOM	50	0.80%	0.30%	0.01%
UNITED STATES	various state taxes	0.17%	0.03%	0.08%

Source: L.H. Summers and V.P. Summers, "When Financial Markets Work Too Well: A Cautious Case For a Securities Tax," *Journal of Financial Services Research*, Vol. 3, 1989, p. 275.

The table includes a wide range of seemingly contradictory entries. Switzerland, with a tax rate not much different from that of Germany, raised twelve times as much revenue in relation to the size of the economy. Switzerland's role as a safe financial haven has resulted at times in an undesirably strong currency due to large capital inflows. The Swiss system of

financial taxes was at times designed specifically to stem this capital inflow,[3] and this might well be the effect being picked up.

Italy, with a relatively low tax rate, generates an impressive amount of revenue. But its tax revenue as a proportion of the market value of equity is so out of line with that of the other countries, and so large, that it appears untenable. The UK tax, which also brings in an ample amount of revenue, taxes away only 0.01% of the market value of equity, far out of line with the tax in other countries, such as Germany, that raise less revenue.

All these contradictions suggest that the design and implementation of taxes vary substantially, and in a way that cannot be captured easily in tabular form.

THE INTERNATIONAL EXPERIENCE[4]

There is not much literature on the international experience with financial transactions taxes. The United Kingdom and Sweden are the two countries whose experiences have been studied most extensively. Although the UK has not had many problems with its tax, the government has announced its commitment to eliminating it. Sweden, on the other hand, abandoned its taxes after they proved to be a disappointing revenue source with wide-ranging negative side effects.

Sweden: In January 1984, Sweden introduced a 50-basis-point tax on the purchase or sale of an equity security. Thus a round trip (purchase and sale) transaction resulted in a 100-basis-point tax. The tax applied to all trades in Sweden using local brokerage services and to stock options. It did not apply to gifts or bequests. In July 1986 the rate was doubled. The next

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(3) P.B. Spahn, *International Financial Flows and Transactions Taxes: Survey and Options*, IMF Working Paper WP/95/60, International Monetary Fund, Washington, D.C., June 1995.

(4) The primary source for this information is K.A. Froot and J.Y. Campbell, *Securities Transactions Taxes: What About International Experiences and Migrating Markets?*, Catalyst Institute, Chicago, Ill., July 1993.

year, a tax at half the normal rate was also applied against trades between dealers. In January 1989, a tax on fixed-income securities was introduced.

The tax on fixed-income securities was considerably less than on equities, as low as 0.2 basis points for a security with a maturity of 90 days or less. On a bond with a maturity of five years or more, the tax was three basis points.

On 15 April 1990, the tax on fixed-income securities was abolished. In January 1991 the rates on the remaining taxes were cut in half and by the end of the year they were abolished completely.

There were several reasons for this change in policy. In the first place, the political climate in Sweden had shifted. The taxes were initially supported because financial transactions were viewed as destabilizing to the economy and as promoting excessive wage differentials. This latter point was distasteful in a society that places so much importance on income equality. The revenues from taxes were disappointing; for example, revenues from the tax on fixed-income securities were initially expected to amount to 1,500 million Swedish kroner per year. They did not amount to more than 80 million Swedish kroner in any year and the average was closer to 50 million.[5]

As taxable trading volumes fell, so did revenues from capital gains taxes, almost entirely offsetting revenues from the equity transactions tax that had grown to 4,000 million Swedish kroner by 1988.[6] (This point is lost entirely in data such as those in Table 1 on page 2, where only direct tax revenues are included.) Another reason for the reduction in capital gains taxes was the decline in share prices associated with the initial announcement of the tax and its increase. On the day that the tax was announced, share prices fell by 2.2%. But there was leakage of information prior to the announcement, which might explain the 5.35% price decline in the 30 days prior to the announcement. When the tax was doubled, prices again fell by another 1%. These declines were in line with the capitalized value of

(5) Froot and Campbell (1993), p. 18.

(6) S.R. Umlauf, "Transaction Taxes and the Behavior of the Swedish Stock Market," *Journal of Financial Economics*, 33 (1993), p. 227-240.

future tax payments resulting from expected trades. It was further felt that the taxes on fixed-income securities only served to increase the cost of government borrowing, providing another argument against the tax.

The Swedish system of taxes also played a very profound role in causing trades to migrate to non-taxed or lower-taxed jurisdictions. With the 1986 announcement that the equity tax would double, 60% of the trading volume of the 11 most actively traded Swedish share classes, accounting for one-half of all Swedish equity trading, moved to London; thus 30% of all Swedish equity trading moved offshore. By 1990, more than 50% of all Swedish trading had moved to London.[7] Foreign investors reacted to the tax by moving their trading offshore while domestic investors reacted by reducing the number of their equity trades.

Even though the tax on fixed-income securities was much lower than that on equities, the impact on market trading was much more dramatic. During the first week of the tax, the volume of bond trading fell by 85%, even though the tax rate on five-year bonds was only three basis points. The volume of futures trading fell by 98% and the options trading market disappeared. Trading in money market securities, which faced a tax as low as 0.2 basis points, fell by 20%. This reaction was due in large part to the existence of a wide variety of non-taxed substitutes. Once the taxes were eliminated, trading volumes returned and grew substantially in the 1990s.

The Swedish results cited above are all consistent with those that economic theory would predict. Events and factors other than the FTT could, however, cause similar results, making it difficult to establish cause-and-effect relationships. The timing and magnitude of the financial market effects lead one to look for dramatic changes in explanatory variables. No such changes were evident in economic or financial variables; however, they were evident in changing institutional (i.e., FTT) variables.

This does not mean that high FTT rates are needed to generate such results. The high rates simply make the cause-and-effect relationship clear. Low rates would likely

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(7) *Ibid.*, p. 229-30.

produce similar qualitative results, albeit of smaller magnitudes, but they might be masked by other factors.

The United Kingdom: The UK tax, actually a stamp duty, is not levied on transactions *per se* but on the registration of securities. Where transactions result in a change of ownership that needs to be registered, the stamp duty comes into effect. This tax does not apply to trades by non-residents, nor does it apply to trades in foreign securities.

This stamp duty has been in effect for many decades. In 1974 it was 2%. In 1984 it was reduced to 1% and in 1986 it was halved. The current plan is to eliminate the tax.

Trades can take place in a variety of ways without changes in registration. For example, brokers may register shares in their own name for the benefit of their customers. It is then possible that clients could be trading shares without any change in the official registration of the shares, as brokers traded shares amongst their own clients. To take this factor into account, the British government taxes the registration of these active nominees at three times the normal rate.

Although the British stamp duty raised about £800 million per year, it did lead to a number of market responses designed to avoid the tax. Bearer securities grew at the expense of registered securities. To some extent, investors switched from equities trading to trading in equity derivatives that provided a similar return. Investors also increasingly used American Depository Receipts (ADRs) which allowed British active nominees to trade assets on American stock markets without incurring British registration duties.

These stamp duties account for about one-half of trading costs in the UK. With an elasticity ranging from -1 to -1.7, the tax could have reduced trading volumes by as much as 50%. This is consistent with the fact that trading volume as a proportion of market value in London is only about 60% the equivalent volume in the US.

Japan: The Japanese government also levies an FTT, which, in the late 1980s, was generating revenues of about US $12 billion per year. The Japanese tax was at that time

levied on both debt instruments (at a rate of three basis points) and equity instruments (at a rate of 30 basis points). Prior to 1988, the tax rate on equity transactions was 55 basis points.[8] More recently, Japan has introduced transactions taxes on derivative products.[9]

EXAMPLES OF FINANCIAL TRANSACTIONS TAXES

The material in this section is taken from a variety of sources,[10] some of which are out of date in certain respects. Not all the sources agree on the set of taxes to include in the FTT category. For example, the Securities Industry Association in the United States claims that no FTT exists in Greece, Portugal or Spain, contrary to what is presented here, based on equally up-to-date information. Also, the IMF study states that Italy does not impose an FTT, even though some minor FTT-type levies do continue to be applied there.

Of the countries listed below, 15 have eliminated or reduced their FTT in the last decade, or plan to reduce it in the near future. It appears to be the intention of the European Commission to recommend that these taxes be abolished, rather than working towards a harmonization of rates.[11] Trading by non-residents or trading in foreign companies is exempt from tax in Finland, France, Ireland, Italy, Switzerland and the United Kingdom.

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(8) L.H. Summers and V.P. Summers, "When Financial Markets Work Too Well: A Cautious Case for a Securities Transaction Tax," *Journal of Financial Services Research*, 1989, p. 261-86.

(9) Y. Masayuki, "Legal and Tax Aspects of Securities Lending Transactions in Japan," *Worldwide Directory of Securities Lending*, 1995-96.

(10) C.S. Hakkio, "Should We Throw Sand in the Gears of Financial Markets?" Federal Reserve Bank of Kansas City, *Economic Review*, Second Quarter; 1994; J.M. Schaefer, C. Hildebrandt and D.G. Strongin, "The International Trend away from Transaction Taxes: Lessons to Be Learned," *Securities Industry Trends*, Vol. XX, No. 4, 18 August 1994; P. Kupiec, A.-P. White and G. Duffee, "A Securities Transaction Tax: Beyond the Rhetoric," in G.G. Kaufman, ed., *Research in Financial Services: Private and Public Policy*, JA1 Press Inc., Greenwich, Conn., 1993; and Spahn (1995).

(11) Kupiec, White and Duffee (1993), p. 61.

Argentina: Transfers of shares are subject to a 100-basis-point stamp duty when made through a written agreement.

Australia: The states impose a transactions tax of six basis points on transactions engaged in by financial institutions. The maximum duty is A$1,500 on any transaction. An additional stamp duty was removed in 1991, at which time the tax was 30 basis points.

Austria: Three types of taxes exist. A capital duty and a securities tax apply respectively to any increase in a company's capital stock and any initial issue of interest-bearing securities. A transactions tax also applies to exchanges in Austria, or elsewhere if one party is Austrian. The rate is four basis points for government bonds and 15 basis points for equities. Taxes can be reduced by trading off the exchange.

Belgium: An exchange tax applies to transfers of financial securities. The tax ranges from a high of 35 basis points to a low of 8.5 basis points. Taxes are subject to maximum amounts and can be avoided by trading outside the country.

Brazil: Borrowers, purchasers of securities or foreign currency and purchasers of insurance pay tax. The rate varies from a low of 0.4 basis points on borrowings to a high of 150 basis points on longer-term debt. A punitive tax of 13000 basis points was levied on some foreign exchange transactions. It has subsequently been abolished for some transactions. At the end of 1994, a temporary 25-basis-point tax on banking transactions was removed.

Canada: There is no FTT.

Chile: There is no FTT, but a stamp duty is applied to a limited set of financial transactions.

China: In Shenzen economic zone a 60-basis-point tax is applied to stock transactions.

Colombia: A limited set of transactions is subject to a stamp duty. The initial issue of stocks and bonds and their transfer are not subject to stamp duty or FTT.

Denmark: All shares sold by a resident of Denmark are subject to a 50-basis-point tax; it was 100 basis points prior to 1995. Financial institutions are not subject to the tax and new issues and transfers due to mergers are not taxed. A stamp duty applies to the issue of new bonds or loan agreements. The rate is 30 basis points for registered securities and 100 basis points for bearer bonds. Non-residents are not subject to Danish tax.

Finland: A 160-basis-point stamp duty applies to the transfer of securities off the exchange. Transfers between non-residents are not subject to duty. A 50-basis-point transactions tax was eliminated in 1992.

France: France levies a stock exchange tax on the transfer of securities at a rate of 30 basis points for small trades and 15 basis points on large trades. These rates apply to both resident buyers and resident sellers so a small trade between two French residents triggers a total tax of 60 basis points. It is only recently that non-residents have been exempted from this tax. Taxes can be avoided by trading outside the country. There is a maximum tax of 4,000 francs per trade and very small trades get a full tax rebate.

A registration tax of 480 basis points was levied on equity capital prior to 1993; it is now 100 basis points. In certain instances another 100-basis-point exchange tax is levied.

Germany: All Germany's taxes were abolished in 1991. Prior to that year, residents paid as much as 18.5 basis points on the sale of stocks while non-residents paid a six-basis-point tax.

Greece: A 30-basis-point transfer tax is imposed.

Hong Kong: Stamp duties are levied on registration documents for financial transactions. The duties are in some instances fixed, ranging from HK $3 to HK $20, and in some instances *ad valorem*, ranging from 25 basis points to 300 basis points.

India: Increases in share capital are subject to registration duty and transactions are subject to stamp duties.

Italy: The transfer of ownership of securities is subject to a registration tax which is levied at a fixed amount. Stamp duties are also applied at a rate of five basis points in certain circumstances. These can be avoided by trading outside the country.

Japan: Securities transactions taxes are levied at rates of 30 basis points for shares and three basis points for government bonds in the event of a sale. These rates were as high as 55 basis points prior to 1990. Transfers by way of gift, bequest or merger are not subject to tax. Securities companies pay a lower tax rate and there is no tax on government money market securities. These taxes can be avoided by trading outside the country.

Luxembourg: No FTT is levied.

Malaysia: A 30-basis-point transfer stamp duty on purchases and sales of securities was eliminated in 1992. A five-basis-point clearing fee is imposed, to a maximum of $100. It may be avoided by trading off the exchange.

Mexico: There is no FTT on the transfer of shares.

Netherlands: No FTT is levied on transactions although every new issue of shares is subject to a capital duty. The Netherlands did impose an FTT in the 1980s at over 100 basis points. It was abolished on 1 July 1990.

New Zealand: Stamp duties are levied on the issue and transfer of financial securities. A transaction levy was eliminated in 1992. A five-cent duty applies to all cheques.

Norway: No FTT is levied.

Portugal: All financial transactions are subject to a stamp tax, applied at varying rates. Incorporation of a new company triggers a stamp tax and registration fee.

Singapore: A stamp duty of 20 basis points was applied to financial transactions prior to 1992. A wide variety of instruments were exempt from the tax and there was a maximum that was applied to debentures. A registration fee is also imposed on new share capital. Other fees equal to 15 basis points are in existence but these can be avoided by trading off the exchange.

South Korea: An FTT of 50 basis points is levied on transactions, although it may be reduced or eliminated by Presidential decree.

Spain: A 600-basis-point transactions tax applies when control of a company changes hands.

Sweden: The Swedish system of transactions taxes was abolished in 1991. At one point the turnover tax was as high as 200 basis points for equities.

Switzerland: A stamp duty applies to the purchase of securities. It is 15 basis points for Swiss securities and 30 basis points for foreign securities. Certain transactions are exempt. These taxes can be avoided by trading outside the country. Rates have been reduced since 1985.

Taiwan: The seller of securities pays an FTT of 30 basis points on the sale of shares and 10 basis points on other transactions. This tax rate was as high as 60 basis points prior to 1993.

United States: There is no FTT. The Securities Exchange Commission charges a modest fee and some states levy small taxes. Until 1965 the United States levied a stamp tax on the issue and transfer of equities and bonds. The rate was 10 basis points or less.

United Kingdom: A stamp duty of 50 basis points applies to the sale of stock and other securities. This duty applies only to domestic securities and a previous government budget proposed the elimination of this duty.

THE FLIGHT FROM TAXATION: LESSONS FOR CANADA

Financial products are probably the most mobile of any goods or services offered by the economy. Modern telecommunications and information-processing technology is making the industry even more footloose. Since these types of transactions can take place without any physical contact between parties, without any physical contact with intermediary agents, and without any physical product moving from one party to another, a Canadian investor can deal almost as efficiently and expeditiously with a broker in New York as with one in Toronto. What is important is that the investor must have confidence that trades take place at agreed-upon times and prices and that ownership of securities can somehow be enforced. Investors also demand competence and market knowledge from their traders and financial advisors. The American financial market has all these characteristics to some extent.

The most dramatic modern example of such migration was the development of the Euro-dollar market in response to American government attempts to control capital exports and place other regulations on the banking system. A financial market dealing in American dollars and American dollar denominated securities developed in London, bypassing completely the United States and American government control. This market grew from US $20 billion in 1964 to over US $3 trillion in gross size by 1988.(12)

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(12) M. Goodfriend, "Eurodollars," in Federal Reserve Bank of Richmond, *Instruments of the Money Market*, 1993; and "The Way We Were," *The Economist*, 3 October 1992.

The migration of Swedish financial transactions was discussed above. But Switzerland, a world banking centre, also suffered from financial migration. Its relatively high transactions on money market funds hindered the development of such an internal market. Its stamp duty also caused the mutual fund business to migrate to Luxembourg and the Eurobond and equity business to go to London. By 1993, 22% of trading in Swiss companies was taking place in London, up from 16% only two years earlier. In 1993, the Swiss government abolished the 15% stamp duty on a wide variety of securities to stem such migration.(13)

The FTT's impact on the location of financial transactions was also felt in Germany and France. In 1989, before the elimination of Germany's taxes, 30% of trading in German government bonds and 50% of trades in other DM-denominated bonds took place in London, as did 80-90% of trades in floating rate DM-denominated bonds.(14) Moreover, about one-third of the trading in French and German public companies took place in London, where almost one-half of the daily volume of trades is in shares of foreign companies.(15)

The City of London has had great success in attracting financial services activity from other countries as a result of regulation and taxation. Thus it is no wonder that one of the most ardent supporters of an American FTT is the London financial community.(16)

The fact that an FTT drove a significant part of Swedish equity trading offshore is very significant for Canada, which, like Sweden, is a relatively small economy with a large and well developed financial market nearby. Canada is even more sensitive to a potential movement of trading and investment activity because of its long history of open capital borders and American investment and the fact that it shares a common language with the U.S.

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(13) "Swiss Finance: On Deaf Ears," *The Economist*, 28 August 1993, p. 72 and 74; and A.W. Lo and J.C. Heaton, *Securities Transaction Taxes: What Would Be Their Effects on Financial Markets and Institutions?*, Catalyst Institute, Chicago, Ill., December 1993.

(14) Kupiec, White and Duffee (1993).

(15) Schaefer, Hildebrandt and Strongin (1994).

(16) J.A. Grundfest, "The Damning Facts of a New Stocks Tax," *The Wall Street Journal*, 23 July 1990.

The Toronto Stock Exchange includes a small number of foreign listings such as British Airways, Fosters Brewing, Benetton, etc. An FTT that made Canadian transactions costs very much more expensive than American could prompt these firms to withdraw their listings here. More importantly, though, about 200 Canadian-based securities are interlisted on the TSE and American exchanges. Some of the prominent Canadian companies with significant foreign trading include: Barrick Gold, Cognos Inc., Cominco Ltd., Gandalf Technologies, Moore Corp., Magna International, Newbridge Network, Northern Telecom, Placer Dome, and Royal Oak Mining. Only 58% of the volume and 55% of the value of trades of these 200 securities took place in Canada during 1995. The rest took place elsewhere, primarily on the New York Stock Exchange, which itself accounted for 29% of the value of trades for Canadian-based firms.(17) The total value of trading of Canadian securities in the United States was $113 billion, representing 45% of equities transactions in Canada, all without an FTT.

Canadian stock exchanges are well aware of the need to be competitive with their American counterparts and are cognizant of their loss of market share. They are seeking to increase co-operation.(18) In addition, the Toronto Stock Exchange in 1994 reduced its maximum trading fee from $1,000 to $100 to win back market share from its American competitors.(19) The close economic and financial ties between Canada and the United States ensure that Canada would not be able to avoid the movement of financial transactions to other jurisdictions, as happened in other countries that had FTTs.

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(17) Toronto Stock Exchange, *Review*, Vol. 61, No. 12, December 1995, Toronto. See also Toronto Stock Exchange, *Official Trading Statistics*, Toronto, 1995.

(18) C. Clark, "ME Would Lose Stock-Trading to Toronto under Co-operation Plan," *The Gazette* (Montreal), 25 January 1996; and "ME Plan Could Offer Escape from the Balkans," *Financial Post*, 25 January 1996.

(19) The Toronto Stock Exchange, *Annual Report, 1994*, Toronto, 1995.